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No. 1023
In the Supreme Court of the United States

WELLS FARGO BANK and A. B. NEIL, JR.,
as Executors of the Will
of Louis L. Pendleton, Deceased.

Petitioners,

vs.

HOWARD C. PLATT, ROBERT C. PLATT, a minor,
and MARILYN A. PLATT, a minor,
by his and her Guardian Ad Litem,
Howard C. Platt,

Respondents.

Petition for Writ of Certiorari to the District Court of Appeal of the State of California First Appellate District

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Petition for Writ of Certiorari to the District Court of Appeal of the State of California First Appellate District

Petitioners, WELLS FARGO BANK and A. B. NEIL, JR., as executors of the will of Louis L. Pendleton, Deceased, pray that a Writ of Certiorari issue to review a Judgment of the District Court of Appeal of the State of California, First Appellate District, Division Two, entered on November 27, 1963. This Judgment affirmed a Judgment of the Superior Court of the State of California in and for the County of San Mateo which had ordered enforcement of a

trust notwithstanding Petitioners' defense that the trust was for a purpose which was illegal under Federal law.

OPINIONS BELOW

The Opinion of the California District Court of Appeal was dated November 27, 1963 (App. 1-15).* It has not yet been officially reported. It is reported unofficially in 222 Adv. Cal. App. 718 and 35 Cal. Reptr. 377. An Opinion dated May 10, 1961 (App. 18-68) was also rendered by the California Superior Court which was the trial court. This Opinion is unreported.

JURISDICTION

Under California practice the Judgment of the District Court of Appeal is comprised in the last paragraph of its opinion. (App. 15) The judgment was dated and entered November 27, 1963. On December 17, 1963 the District Court of Appeal made an Order denying Petitioners' petition for a rehearing (App. 16); and on January 22, 1964, the Supreme Court of the State of California made its Order denying Petitioners' Petition for a Hearing by that court. (App. 17.)

The jurisdiction of this court is invoked under 28 U.S.C. § 1257(3).

QUESTIONS PRESENTED

1. Do the principles which preclude court enforcement of illegal transactions apply to transactions entered into for the purpose of accomplishing an unlawful evasion of taxes under the Internal Revenue Code? If so, will enforcement or nonenforcement of a patently evasive transac-

*In view of the total length of the two opinions below to be printed, the Appendix material is presented under separate binding.

tion depend on the subjective good or bad faith of the parties?

2. Should court enforcement be granted for a constructive trust which was created for the purpose of enabling the parties to make a false claim to the benefit of the marital deduction in the determination of Federal Estate Taxes?

3. Under the Federal Estate Tax law, is the marital deduction allowable for property given by will, apparently outright, to a surviving spouse where the testator executed the will in reliance upon oral and written agreements of the surviving spouse that the spouse would hold a life estate only and that the property would thereafter go to third parties designated by the testator?

STATUTES AND REGULATIONS INVOLVED

Section 812 of the Internal Revenue Code of 1939 (as amended by the Revenue Act of April 2, 1948, ch. 168, § 361(a), 62 Stat. 117), 26 U.S.C. 812 (1952 Ed.)* provided in relevant part as follows:

"§ 812. *Net estate.*

For the purpose of the tax the value of the net estate shall be determined, in the case of a citizen or resident of the United States by deducting from the value of the gross estate—"

* * * * * * *

"*(e) Bequests, etc., to surviving spouse.*

(1) Allowance of marital deduction.

(A) In general. An amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

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*The counterpart of the quoted provisions under the 1954 Internal Revenue Code is 26 U.S.C. 2056(a), (b)(1)(A)-(B).

(B) Life estate or other terminable interest. Where, upon the lapse of time, upon the occurrence of an event or contingency, or upon the failure of an event or contingency to occur, such interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed with respect to such interest—

(i) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

(ii) if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse;"

Estate Tax Regulations, 26 C.F.R. § 81.47b(d) (1949 Ed., pocket supp.)*, added by Treasury Decision 5699 of May 19, 1949, 14 F.R. 2633, provided in relevant part as follows:

"(d) *Interest in property which another person may possess or enjoy.* (1) Section 812 (e) (1) (B) provides that no marital deduction shall be allowed with respect to certain property interests (referred to generally as 'terminable interests') which passed from the decedent to his surviving spouse, in case:

(i) An interest in the same property passed at any time (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such spouse (or the estate of such spouse), and

(ii) By reason thereof, such person (or his heirs or assigns) may possess or enjoy any part of such prop-

*Counterpart of this provision appears in the present regulations in 26 C.F.R. § 20.2056(b)-1.

erty after the termination or failure of the interest therein which passed from the decedent to his surviving spouse.

(2) The foregoing provision is applicable only where interests in the same property passed from the decedent both to his surviving spouse, and to some other person (for less than an adequate and full consideration in money or money's worth), and is applicable irrespective of whether both such interests passed from the decedent at the same time or under the same instrument. Under such circumstances, if the other person to whom an interest passed may, by reason thereof, possess or enjoy any part of the property after the termination or failure of the interest therein which passed from the decedent to his surviving spouse, the latter interest is a 'nondeductible interest'."

Estate Tax Regulations, 26 C.F.R. § 81.47a(b)(2)(ii) (1949 Ed., pocket supp.)*, added by Treasury Decision 5699 of May 19, 1949, 14 F.R. 2629, provided in relevant part as follows:

"The deduction may not be taken with respect to a property interest which passed to such spouse merely as trustee, or subject to a binding agreement by such spouse to dispose of such interest in favor of a third person."

STATEMENT OF THE CASE

In 1948, by amendment of the Internal Revenue Code, Congress provided for the marital deduction in the determination of a decedent's taxable estate for Federal Estate Tax purposes. The deduction can be taken for property up to one-half of the "gross estate" bequeathed by a decedent to his surviving spouse. The deduction is expressly

*Substantially the same provision appears in the present regulations in 26 C.F.R. § 20.2056(e)-2(a).

limited, however, to property which passed to the surviving spouse outright and with no other person designated by the decedent to take the property upon the death of the spouse or other contingency. The deduction is not permitted for "terminable interests" (Int. Rev. Code 1939 § 812(e)(1)(B), quoted *supra* p. 4 and 1954 Code § 2056 (b)(1)). Thus, if the decedent has limited his surviving spouse to a life estate, the marital deduction is not available.

In the present case, the decedent, Gladys Pendleton, who was making a new will in October 1949, desired to limit her spouse, Col. Pendleton, to a life estate with the remainder interest to go to her nephew, Howard Platt, and his family. (Opinion on Appeal, App. 1-3; Findings, Cl. Tr. 356-7; R. Tr. 25.)* She also wanted her estate to have the benefit of the marital deduction. (R. Tr. 273, 281, 1146; see Opinion on Appeal, App. 2.) In order to accomplish this dual objective, the decedent, her husband, and her nephew entered into the following arrangement:

The decedent made a will in which one-half of the residue of her estate was left to her husband, apparently outright and without restriction; and the other one-half of the residue was bequeathed to the decedent's nephew, Howard Platt (Opinion on Appeal, App. 1). Prior to making the will, however, the decedent had received promises from her husband and her nephew that upon distribution of the residue of her estate to them, they would place the same in an irrevocable trust in which her husband would be limited to a life estate in a portion of the property and in which the property, upon her husband's death, would go to Howard Platt and members of his family. (Findings, Cl. Tr. 358.) Col. Pendleton and Howard Platt further

*"Cl. Tr." refers to Clerk's Transcript, and "R. Tr." refers to Reporter's Transcript of proceedings in the trial court.
"Findings" refers to Findings of Fact made by the trial court.

agreed with Mrs. Pendleton that they would sign a written agreement to this effect (Findings, Cl. Tr. 358). The written agreement* was read to and approved by Mrs. Pendleton prior to her execution of the will and was in fact signed on the same day. (Findings, Cl. Tr. 359; R. Tr. 64, 84, 333.) Mrs. Pendleton made her will in reliance upon these arrangements by which her husband was to be limited to a life estate and upon his death the property would go to the others whom she designated (Findings, Cl. Tr. 358, 398, 403).

In previous wills Mrs. Pendleton had provided for her husband's life estate by a testamentary trust (Findings, Cl. Tr. 354-355). The purpose of the changed arrangements was to secure the benefits of the marital deduction. (See Opinion of District Court of Appeal quoted *infra*, p. 10; R. Tr. 267-8, 276, 287, 1222-4.) This would be accomplished on the basis of the outright bequest to Col. Pendleton in Mrs. Pendleton's will, and Col. Pendleton would still be limited through the secret† trust to a life estate. This purpose was in fact carried out. Mrs. Pendleton died in 1950, and Howard Platt and Col. Pendleton, as co-executors of her estate, executed and filed a Federal Estate Tax Return in which the marital deduction was claimed on the basis of the outright bequest of one-half of the residue of the estate to Col. Pendleton without disclosure of the secret trust which would limit Col. Pendleton to a non-qualifying

*The terms of the written agreement are summarized in the Opinion on Appeal (App. 2-3). The agreement is set forth at length in the Opinion of the trial court. (App. 26-27).

†Constructive trusts of the type herein involved are recognized in California and have been referred to as "secret" trusts. *Gagner v. Purcell* (1916) 173 Cal. 495, 499, 160 Pac. 682, 684; *In re Sharp* (1911) 17 Cal. App. 634, 636, 120 Pac. 1079, 1080; *Prior v. Andrews* (1927) 83 Cal. App. 782, 791, 257 Pac. 560, 564.

life estate (Findings, Cl. Tr. 395). The question in the Federal Estate Tax Return schedule as to whether any person other than the surviving spouse claimed or contemplated claiming any interest in the property listed as passing to the surviving spouse was answered, "No". (Opinion on Appeal, App. 4.) As a result, some $36,000 in Federal Estate Taxes were evaded (R. Tr. 790-91).

The parties had had the advice of an attorney in planning and carrying out the foregoing arrangements. Counsel had advised that the marital deduction would not be allowable if Col. Pendleton were limited to a life estate by a testamentary trust (R. Tr. 1147) but that if Mrs. Pendleton made an outright bequest in her will, then her husband and her nephew could make any agreement between themselves which they desired, so long as no restrictions on the outright bequest "emanated" from Mrs. Pendleton (Opinion on Appeal, App. 2). Later on counsel prepared the Federal Estate Tax Return which the parties executed and filed. (Findings, Cl. Tr. 395.) Although the scheme which the parties adopted was so obviously evasive that Howard Platt himself referred to it as "shenanigans" (R. Tr. 63), the trial court found that the parties did what they did in good faith in reliance upon counsel's advice and without deliberate intent to violate the Federal law (Findings, Cl. Tr. 393, 395).

The trust was never fully activated, and in 1959 Howard Platt and his two children, Robert and Marilyn Platt, Respondents herein, filed this action to enforce the trust in the Superior Court in San Mateo County, California. (App. 5; Cl. Tr. 1.)

Col. Pendleton died prior to the trial of the case, and his executors, Petitioners herein, were substituted for him in the litigation (App. 6).

Raising and Disposition of Federal Questions in Courts Below.

The federal question as to the consequences of the illegality of the purpose of the transaction under the Federal Estate Tax law has been the primary issue throughout the case. It was first raised in Col. Pendleton's first adversary appearance by demurrer filed January 13, 1960. In the demurrer defendant specifically asserted illegality under § 812(e) of the Internal Revenue Code of 1939 (Cl. Tr. 85-6). The trial court overruled the demurrer without opinion (Cl. Tr. 89).

In defendants' answer filed May 3, 1960, the illegality under the Federal Estate Tax law was reasserted at length as defendants' first affirmative defense. (Cl. Tr. 97-101; see Opinion on Appeal, App. 6.) Petitioners alleged in substance that the purpose of the secret trust was to permit a false claim to the marital deduction under the Federal Estate Tax law and that this illegality barred any enforcement of the trust.

This issue of illegality under the federal law was reiterated in the defendants' pre-trial statement (Cl. Tr. 165) and in the court's pre-trial order (Cl. Tr. 150).

The trial court, in its Opinion (App. 16-68), Findings of Fact and Conclusions of Law (Cl. Tr. 352-463; 517-528) and Judgment (Cl. Tr. 465-491; 529-571), held that the trust should nevertheless be enforced. The fact that the parties acted on advice of counsel without any deliberate intent to violate the law was one of the factors which influenced the court's decision. The trial court was also impressed with the view that the rules against enforcement of illegal transactions were inapplicable to transactions involving evasion of Federal taxes. (See Opinion of trial court, App. 48-51.)

Again, on Petitioners' appeal to the California District Court of Appeal the illegality issue under the Federal Es-

tate Tax law was the primary issue raised by Petitioners. In accordance with California practice, the issue was raised in Petitioners' Appellate Brief. (See quotations from Brief, App. 69-70.) The California District Court of Appeal, in its Opinion, recognized that this was the principal issue presented for its determination (App. 6).

The District Court of Appeal, in affirming the Judgment of the trial court, relied upon the finding of good faith in acting on advice of counsel as a sufficient answer to the illegality (App. 7-10), although it agreed that:

> "There is no doubt that the objective of the parties in entering into the agreement was to obtain the marital tax deduction, while still carrying out Mrs. Pendleton's wishes with respect to the disposition of the Folger stock." (App. 6)

The issue of illegality under the Federal Estate Tax law was again raised as the principal issue in Petitioners' Petition for a Hearing in the California Supreme Court. (See excerpts from Petition for California Supreme Court Hearing, App. 75-76.) The California Supreme Court denied the Petition for Hearing without comment (App. 17).

The third Federal question presented is whether or not it was actually improper to take the marital deduction under the circumstances of the case. This question has been raised implicitly throughout the case in that a necessary element of Petitioners' contention that the court should not enforce the trust because of illegality under Federal law is that there was in fact some illegality. Thus, throughout the case, Petitioners have taken the position that Mrs. Pendleton was instrumental in limiting her husband to a terminable interest and it was therefore illegal to take the marital deduction.

No serious question was ever raised as to the correctness of this position, at least until the decision of the California

District Court of Appeal. Although the Court's Opinion is not clear on the point, it appears possible that the Court may have based its judgment in part upon the proposition that that no illegality under the Federal Estate Tax law was necessarily involved in the transaction. The court, in its Opinion, refers to the advice of counsel to the effect that Col. Pendleton and Howard Platt, as legatees under Mrs. Pendleton's will could make any agreement between themselves as to the ultimate disposition of the property which they might desire, and that so long as the limitation of Col. Pendleton to a life estate did not "emanate" from Mrs. Pendleton, this would not affect the allowability of the marital deduction under the Federal Estate Tax law (App. 2). The court, in referring to the objective of the parties of obtaining the marital deduction on this basis states:

> "As an abstract matter, this is not an illegal objective." (App. 6)

The facts of the case as found by the trial court, however, were that Mrs. Pendleton made her will with the outright bequest in reliance upon the oral and written agreement of Col. Pendleton and Howard Platt that the property would be placed in a trust in which Col. Pendleton would be limited to a life estate. (See *supra*, p. 7.) The District Court of Appeal did not, in any way modify these findings, and we should state frankly that we do not believe that the Court actually intended to hold that the marital deduction could properly be taken under these circumstances. It has appeared desirable to present the question, however, in order to cover all possible explanations of the Court's decision. If the Court's Opinion is to be construed as holding that under these facts the marital deduction could properly be taken in the determination of Federal Estate Taxes, then this third Federal question has definitely been brought into the case.

In Petitioners' Petition to the District Court of Appeal for a Rehearing, Petitioners pointed out that Mrs. Pendleton had been instrumental in placing restrictions on the bequest to her husband, and Petitioners asked for clarification of the court's Opinion on this point. (See quotation from Petition for Rehearing, App. 70-75.) The District Court of Appeal denied the Petition for Rehearing without comment (App. 16).

This question arising under the Opinion of the District Court of Appeal was also brought to the attention of the California Supreme Court in Petitioners' Petition for a Hearing by that court. (See quotation from Petition for Hearing, App. 75-76.) The California Supreme Court denied the Petition without comment (App. 17).

Respondents, in their reply to the Petition for Hearing by the California Supreme Court, agreed with Petitioners' contention that under the facts of the case the restriction of Col. Pendleton to a life estate was a limitation placed by Mrs. Pendleton. (See quotation from Respondents' Reply, App. 76-77.) This, Respondents agreed, was the whole basis of the case which the District Court of Appeal had before it to decide. Thus, if the District Court of Appeal Opinion is to be construed as holding that since Col. Pendleton and Howard Platt also had a written agreement between them, it was legal to take the marital deduction regardless of the part played by the decedent, then the third Federal question, under the Federal Estate Tax law, is presented.

REASONS FOR GRANTING THE WRIT

The Questions Presented are Federal Questions.

Many decisions of this court have demonstrated that when Federal law is involved it is the province of this court not only to construe its express provisions, but also to determine

the extent and nature of the legal consequences of any violation, even though the transaction is between private litigants and on its face presents nothing more than a local question. Thus, the Federal aspect of a transaction involving Federal law is not confined to the construction and application of the express provisions of the law. It extends to all consequential phases, for here the policy of the law and the intent of Congress may be just as important as its express provisions.

Sola Electric Co. v. Jefferson Electric Co., 317 U.S. 173 (1942). This was an action to recover royalties and enforce a patent licensing agreement. The defendant contended that the agreement, which contained a price fixing clause, was in violation of the Sherman Act. Plaintiff argued that defendant was estopped to assert this defense. This Court held that the question of estoppel was a matter of Federal law to be decided in accordance with Federal policy. The Court stated:

> "When a federal statute condemns an act as unlawful, the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted. To the federal statute and policy, conflicting state law and policy must yield."
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> * * * * * * *
>
> "A state by applying its own law of specific performance may not compel the performance of a contract contemplating violation of the federal land laws. *Anderson v. Carkins*, 135 U.S. 483, 34 L.Ed. 272. Similarly this Court has declared that anyone sued upon a contract may set up as a defense that it is in violation of the Sherman Act. *E. Bement & Sons v. National Harrow Co.*, 186 U.S. 70, 88, 46 L.Ed. 1058, 1067. And it has proceeded on the assumption that whether the parties to

> an agreement in violation of the Act are in pari delicto is a question of federal, not state, law. *Harriman v. Northern Securities Co.*, 198 U.S. 244, 49 L.Ed. 739; *Eastman Kodak Co. v. Southern Photo Materials Co.*, 273 U.S. 359, 376-378, 71 L.Ed. 684, 690, 691. * * *" (317 U.S. at 176, 177)

See also *Katzinger v. Chicago Metallic Mfg. Co.*, 329 U.S. 394 (1947).

MacGregor v. Westinghouse Elec. & Mfg. Co., 329 U.S. 402 (1947), (reversing Pennsylvania Supreme Court on certiorari).

Similarly, questions of enforceability of transactions which involve some element of illegality under Federal law are Federal questions. This, of course, is obvious where Congress has legislated specifically as to the consequences of illegality. But whether Congress has been specific on the subject or not, the effect of illegality under Federal law is still a Federal question.

Bruce's Juices v. American Can Co., 330 U.S. 743 (1947). This was an action in the Florida state courts to enforce renewal promissory notes. The defendant contended that the notes were illegal and unenforceable because they arose out of sales by the plaintiff which were discriminatory in violation of the Robinson-Patman Act. This Court heard the case on certiorari, and held that this question of illegality was a Federal question. The Court stated:

> "The federal question which survives proceedings in the Florida state courts is whether renewal notes representing the purchase price of goods sold and delivered are uncollectible if it is found that the vendor violated the Robinson-Patman Act". (330 U.S. at 744)

Kelly v. Kosuga, 358 U.S. 516 (1959). This was an action for the purchase price of fifty cars of onions. The buyer de-

fended on the ground of illegality under the Sherman Act. This Court recognized that the question was a Federal question when it stated:

> "Obviously, state law governs in general the rights and duties of sellers and purchasers of goods, and, while the effect of illegality under a federal statute is a matter of federal law, * * *". (358 U.S. at 519)

A. C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38 (1941). This court, in reversing an Idaho Supreme Court decision on certiorari, held that the effect of illegality under the Securities Act of 1933 was a Federal question.

Deitrick v. Greaney, 309 U.S. 190 (1940), involved enforcement of note given to a bank for a consideration which was illegal under the National Bank Act. The United States Supreme Court stated:

> "A point much discussed in brief and argument, upon the assumption that local law will guide our decision, see *Erie R. Co. v. Tompkins*, 304 U.S. 64, is whether by Massachusetts law * * * [defendant] is precluded from setting up the illegality of the transaction as a defense to his note. But it is the federal statute which condemns as unlawful * * * [defendant's] acts. The extent and nature of the legal consequences of this condemnation though left by the statute to judicial determination, are nevertheless to be derived from it and the federal policy which it has adopted * * *. We have recently held that the judicial determination of the legal consequences which flow from acts condemned as unlawful by the National Bank Act involves decision of a federal, not a state question." (309 U.S. at 200-201)

Awotin v. Atlas Exchange National Bank, 295 U.S. 209 (1935). This was an action in the Illinois state courts against a national bank for breach of an agreement by the bank to repurchase certain bonds. It was contended that this agreement was illegal under the National Bank Act. This Court

granted certiorari. This Court held that the question of enforceability and also the question of plaintiff's right to restitution in the absence of enforcement were Federal questions. See also *Kimen v. Atlas Exchange National Bank*, 295 U.S. 215 (1935).

D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp., 315 U.S. 447 (1942).

Sage v. Hampe, 235 U.S. 99 (1914), involved a contract for the sale of certain land in Kansas. The land was owned by an Indian patentee under act of Congress which contained certain limitations on transferability of the land. The Kansas Supreme Court had held the contract to be enforceable since the Indian patentee was not a party to the contract and the Congressional limitations did not apply directly to the contract. Justice Holmes, speaking for this Court, held that even though the parties were not expressly subject to the Congressional restrictions, still the contract was illegal because of the tendency to promote illegality under the Federal act. Justice Holmes further held that this was a Federal question. His Opinion is certainly applicable here:

> "The only doubt open in the present position of the case is whether the ground upon which we hold the contract unenforceable is not a matter of common law, which we may think that the Kansas courts ought to apply, but which is not open to review here. The case at first sight seems like those in which a state decides to enforce or not to enforce a domestic contract notwithstanding or because of its tendency to cause a breach of the law of some other state. [Citations omitted] But the policy involved here is the policy of the United States. It is not a matter that the states can regard or disregard at their will." (235 U.S. at 106)

It is thus clear that where illegality under Federal law is involved, the effect of such illegality upon enforceability of private transactions is a question of the policy of the Federal law to be passed upon by this court. It is also clear that the existence of the Federal question is not dependent upon its being labeled as such. It is the inherent nature of the question which controls. (See *Deitrick v. Greaney* 309 U.S. 190 (1940) *supra* p. 15.)

The third question reviewed above is also clearly a Federal question. It involves the construction of the express provisions of the Internal Revenue Code § 812(e)(1)(B) concerning terminable interests. If the California District Court of Appeal has held that under the circumstances of this case the bequest to the surviving spouse was not a terminable interest, then certainly we have a question which should be decided on a uniform basis for the whole country without regard to how any particular state court might apply its own local law to these facts.

Burnet v. Harmel, 287 U.S. 103 (1932);
Lyeth v. Hoey, 305 U.S. 188 (1938);
United States v. Pelzer, 312 U.S. 399 (1941);
Rogers' Estate v. Helvering, 320 U.S. 410 (1943).

The Question of Enforceability of Tax Evasion Transactions Is of Paramount Importance and Should Be Decided by This Court.

The basic issue in this case is whether or not court enforcement should be granted to a transaction entered into for the purpose of accomplishing an evasion of Federal taxes. An incident of this question is the weight to be attached to the subjective good faith of the parties in the patently evasive transaction.

Our research has revealed no case in which this court has decided these illegality question in the tax field. This court has, however, had frequent occasion to enunciate

the general principles concerning court enforcement of illegal transactions in other areas of the law. The general principle that the courts should not enforce illegal transactions or transactions entered into for an illegal purpose has been fully recognized. The importance of discouraging illegal transactions far outweighs the importance of adjusting the private equities of the parties. Thus, when a party must rely upon a transaction tainted with illegality in order to establish his case, the courts cannot help him. The policy is "hands off".

Thus, in *McMullen v. Hoffman*, 174 U.S. 639 (1899), a case which arose out of a collusive bidding arrangement, the Court stated:

> "The authorities from the earliest time to the present unanimously hold that no court will lend its assistance in any way towards carrying out the terms of an illegal contract. In case any action is brought in which it is necessary to prove the illegal contract in order to maintain the action, courts will not enforce it, nor will they enforce any alleged rights directly springing from such contract."
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> "The court refuses to enforce such a contract, and it permits defendant to set up its illegality, not out of any regard for the defendant who sets it up, but only on account of the public interest. It has been often stated in similiar cases that the defense is a very dishonest one, and it lies ill in the mouth of the defendant to allege it, and it is only allowed for public considerations and in order the better to secure the public against dishonest transactions. To refuse to grant either party to an illegal contract judicial aid for the enforcement of his alleged rights under it tends strongly towards reducing the number of such transactions to a minimum. The more plainly parties understand that when they enter into contracts of this nature they place themselves outside the protection of the law, so far as that protection consists in aiding them to enforce such

> contracts, the less inclined will they be to enter into them. In that way the public secures the benefit of a rigid adherence to the law." (174 U.S. at 654, 669)

In *Dent v. Ferguson*, 132 U.S. 50 (1889), the Court refused to enforce a secret trust under which a grantee of property conveyed in fraud of creditors had agreed to return the property to the grantor. The court stated:

> "It * * * involves a secret trust for the return to himself of property of which such creditors have the immediate right of sale. The law does not countenance any such transaction, but leaves both parties in the position where they have placed themselves." (132 U.S. at 67)

Application of this rule of nonenforcement is not dependent on express statutory language to the effect that violative transactions shall not be enforceable.

United States v. Mississippi Valley Generating Co., 364 U.S. 520, 563 (1961) quoted *infra*, page 21.

Hazelton v. Sheckels, 202 U.S. 71 (1906) (Contract against public policy)

Application of the rule against nonenforcement is not confined to transactions which expressly call for a violation of the law. The mere tendency to promote illegality or a purpose to accomplish an illegal objective provide adequate reason for court refusal to enforce. In *Sage v. Hampe*, 235 U.S. 99 (1914) (reviewed *supra*, page 16), the statute involved was an act of Congress which barred any conveyance of land by an Indian patentee for a period of 25 years without approval of the Secretary of Interior. This Court held that under this law a contract for the sale of the land by a seller who did not own the land and who was not directly subject to the congressional act, was illegal

because of the tendency which the contract would induce to attempt to get the land away from the Indian owner in violation of the intent of Congress. Justice Holmes, speaking for the Court, stated:

> "And more broadly, it long has been recognized that contracts that obviously and directly tend in a marked degree to bring about results that the law seeks to prevent cannot be made the ground of a successful suit. Providence Tool Co. v. Norris, 2 Wall. 45, 17 L. ed. 868; Trist v. Child (Busk v. Child) 21 Wall. 441, 22 L. ed. 623; Oscanyan v. Winchester Repeating Arms Co., 103 U. S. 261, 26 L. ed. 539; Fuller v. Dame, 18 Pick. 472. It appears to us that this is a contract of that class. * * *"
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> "It is true that later statutes in force when the contract was made allowed a conveyance with the approval of the Secretary of the Interior. * * * The Kansas court laid these statutes on one side, and in our view also they do not affect the case. The purpose of the law still is to protect the Indian interest, and a contract that tends to bring to bear improper influence upon the Secretary of the Interior, and to induce attempts to mislead him as to what the welfare of the Indian requires, are as contrary to the policy of the law as others that have been condemned by the courts." (235 U.S. at 105)

Woodstock Iron Co. v. Richmond & Danville Extension Co., 129 U.S. 643 (1889). This Court stated:

> ". . . agreements like the one in this case; . . . are against public policy because of their corrupt tendency, whether lawful or unlawful means are contemplated or used in carrying them into execution. 'The law, . . . looks to the general tendency of such agreements; and it closes the door to temptation by refusing them recognition in any of the courts of the country.'" (129 U.S. at 663)

See also *Weil v. Neary*, 278 U.S. 160 (1929), quoted *infra*, pages 22-23.

In the great majority of the illegality cases the courts' ruling against enforcement is based upon the actual illegality inherent in the transaction or in its purpose, without regard to the subjective good or bad faith of the parties. There have, however, been some cases before this court in which a party has contended that the usual rules of illegality should not be applied because the parties acted in good faith and without any evil fraudulent intent. Thus, in *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520 (1961), involving a government contract in which there was a conflict of interest on the part of one of the negotiators, this Court held:

> "Having determined that Wenzell's activities constituted a violation of Section 434, we must next consider whether Wenzell's illegal conduct renders the contract unenforceable. It is true that Section 434 does not specifically provide for the invalidation of contracts which are made in violation of the statutory prohibition. However, that fact is not determinative of the question, for a statute frequently implies that a contract is not to be enforced when it arises out of circumstances that would lead enforcement to offend the essential purpose of the enactment. e. g., Miller v. Ammon, 145 U.S. 421, 36 L ed 759, 12 S Ct 884; Bank of United States v. Owens (US) 2 Pet 527, 7 L ed 508; 6 Williston, Contracts (rev ed 1938) § 1763.
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> "The Court of Claims was of the opinion that it would be overly harsh not to enforce this contract, since the sponsors could not have controlled Wenzell's activities and were guilty of no wrongdoing. However, we think that the court emphasized the wrong considerations. Although nonenforcement frequently has the effect of punishing one who has broken the law,

"its primary purpose is to guarantee the integrity of the federal contracting process and to protect the public from the corruption which might lie undetectable beneath the surface of a contract conceived in a tainted transaction. Cf. Crocker v. United States, 240 US 74, 80, 81, 60 L ed 533, 537, 36 S Ct 245. It is this inherent difficulty in detecting corruption which requires that contracts made in violation of Section 434 be held unenforceable, even though the party seeking enforcement ostensibly appears entirely innocent. Cf. Hazelton v. Sheckels, 202 US 71, 79, 50 L ed 939, 941, 26 S Ct 567, 6 Ann Cas 247." (364 U.S. at 563, 564)

United States v. Trans-Missouri Freight Association, 166 U.S. 290 (1897), a case arising under the Sherman Act:

"For these reasons the suit of the government can be maintained without proof of the allegation that the agreement was entered into for the purpose of restraining trade or commerce or for maintaining rates above what was reasonable. The necessary effect of the agreement is to restrain trade or commerce, no matter what the intent was on the part of those who signed it." (166 U.S. at 342)

Harriman v. Northern Securities Co., 197 U.S. 244 (1905), also involved the Sherman Act. The Court stated:

"We regard the contention that complainants are exempt from the doctrine *in pari delicto* because the parties acted in good faith and without intention to violate the law as without merit. With knowledge of the facts and of the statute, the parties turned out to be mistaken in supposing that the statute would not be held applicable to the facts." (197 U.S. at 298)

Weil v. Neary, 278 U.S. 160 (1929), a case involving an agreement to divide fees in a bankruptcy matter:

"The chief argument that is pressed upon us to declare the contract valid and to sustain the judgment

based upon it is the success with which the plaintiff is found to have worked out a useful settlement of the estate for the benefit of the creditors, and the absence of any finding or showing that there was actual fraud. But this is not a sufficient answer to the charge of illegality. The contract is contrary to public policy—plainly so. What is struck at in the refusal to enforce contracts of this kind is not only actual evil results but their tendency to evil in other cases. Even if the ultimate results in the management of the Thompson estate were good that could be no excuse for a contract plainly illegal, because tending to produce the recognized abuses which follow fraud and disloyalty by agents and trustees. Enforcement of such contracts, when actual evil does not follow, would destroy the safeguards of the law and lessen the prevention of abuses. Providence Tool Co. v. Norris, 2 Wall. 45, 17 L. ed. 868; Woodstock Iron Co. v. Richmond & D. Extension Co. 129 U.S. 643, 32 L. ed. 819, 9 Sup. Ct. Rep. 402; Oscanyan v. Winchester Repeating Arms Co. 103 U.S. 261, 26 L.ed. 539; Maguire v. Corwine, 101 U.S. 108, 25 L.ed. 899; Connors v. Connolly, 86 Conn. 641, 45 L.R.A. (N.S.) 564, 86 Atl. 600; Richardson v. Crandall, 48 N.Y. 348; Palmbaum v. Magulsky, 217 Mass. 306, 308, 104 N.E. 746, Ann. Cas. 1915D, 799." (278 U.S. at 173)

There are numerous decisions of this court as to just how these basic principles on illegality should be applied in particular fields of Federal law. (See cases reviewed at pages 13 to 16, *supra*, arising under Sherman Act, Robinson-Patman Act, Securities Act of 1933, and National Bank Act.) The rules applicable in one field are not necessarily conclusive, however, as to the proper rules in other fields. See for example *A. C. Frost & Co. v. Coeur D'Alene Mines Corp.*; 312 U.S. 38 (1941) in which non-enforcement would have hindered rather than helped the purposes of the Securities Act of 1933. In each field this court must consider the

policy and purpose of the enactment in question and the intent of Congress, together with the circumstances of the particular case, in establishing principles as to what transactions are and what transactions are not enforceable. Compare also *Bruce's Juices v. American Can Co.*, 330 U.S. 743 (1947) *supra*, p. 14.

So far as we have been able to ascertain, this court has never made any corresponding determination under the Internal Revenue Code. The Internal Revenue Code is probably the most important law we have, both from the standpoint of government revenues and from the standpoint of the number of persons affected. "No other branch of the law touches human activities at so many points." *Dobson v. Commissioner*, 320 U.S. 489, 494-495 (1943). But on this very vital question of enforceability of Federal tax evasion transactions, this court has made no adjudication.

We should point out that we are not here concerned with some incidental violation of the revenue laws. In the present case the whole purpose of the secret trust for which enforcement is sought was to accomplish an unlawful evasion. Decisions involving perfectly legal transactions where there may be some incidental violation of the tax law involved are consequently inapplicable. (Compare, for example, *Cole v. Ralph*, 252 U.S. 286, 293 (1920), in which failure to affix revenue stamps did not invalidate a conveyance made for a perfectly legal purpose.

Decisions of the state courts have been of little assistance in solving the enforceability question where the actual purpose is Federal Tax evasion. As a matter of fact, there is a conflict. On the one hand we refer to the decision of the California District Court of Appeal in the instant case. We refer also to *Hansen v. Bear Film Company*, 28 Cal. 2d 154, 168 P. (2d) 946 (1946), in which the California Supreme Court said in a suit to enforce a resulting trust:

". . . if the transaction resulted in evasion under the federal taxing statutes, that is an exclusive concern of the federal authorities." (28 Cal. 2d at 176; 168 P. (2d) at 960.)

See also *Farber v. John Aquino Sons*, 3 N.Y. Supp. (2d) 236, 253 App. Div. 600 (1938);

Christopherson & Kiaer v. U. S. Navigation Co., 202 N.Y. Supp. 902, 121 Misc. 778 (1923).

On the other hand, decisions in other states have treated a purpose to evade Federal taxes as grounds for court refusal to enforce a transaction. Thus, in *Shaw v. Addison*, 239 Iowa 377, 28 N.W.2d 816 (1947), the court refused to enforce a trust created for the purpose of evading Federal* income tax. The court stated:

"Plaintiff, as heir of the donor, had no rights superior to those of the donor at the time of his death. The transfer which has for its object and purpose the evasion of taxation is analogous to transfers to defraud creditors about which more will be said in the next division of this opinion. In both cases the parties are in pari delicto and no relief will be granted the transferor in equity but the law will leave them where it finds them. The equitable maxim 'he who comes into equity must come with clean hands' governs the court's action. No resulting trust, that a court of equity will enforce, is established in favor of the transferor, or his successor upon proof of a transfer made for the purpose of evading tax." (28 N.W.2d at 826)

See also *Creekmore v. Chitwood*, 7 Bush (70 Ky.) 317 (1870).

Collins v. Becklenberg, 236 Ill. App. 324 (1925);

Curran v. Down, 3 Mo. App. 468 (1877).

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*The transfers in this case alleged as the basis for the trust were in 1922 and 1929 prior to the enactment of the Iowa income tax law. (Iowa Acts 1933-34 Ex. Sess. (45 G. A.) ch. 82.) Hence, the income taxes referred to were exclusively federal.

Congress has not provided any clear-cut answer to the question. Congress has provided criminal sanctions (e.g., Internal Revenue Code of 1954, 26 U.S.C. §§ 7201-7215) and civil penalties (e.g., 26 U.S.C. § 6653) for various types of violations. In isolated situations, largely where the purpose of the tax is regulatory, Congress has made specific provisions for forfeitures or for the application of the law to private transactions. For example, under the 1954 Code:

26 U.S.C. § 4706, 4714 (Forfeiture of narcotics);

26 U.S.C. § 4853 (b) (Sale of cotton futures—specific prohibition intended; See *Hubbard v. Louy*, 226 Fed. 135, 137 (S.D.N.Y. 1915);

26 U.S.C. § 5612, 5613 (Alcoholic Beverage forfeitures);

26 U.S.C. § 7302 (No property rights in property used for violation—See *U.S. v. Dixon*, 347 U.S. 381 (1954))

26 U.S.C. § 7341(a) (Voiding debts incurred for purchase of property sold with intent to avoid tax.)

Congress has not, however, legislated on the general subject of enforceability of tax evasion transactions, and our review of the legislative history of the above special provisions has not provided any definite clue as to the intent of Congress on the general question. It could be argued that the various specific laws which Congress has enacted preclude any broader congressional intent on the subject. We submit that it is much more probable, however, that the congressional intent is that the courts should apply the established general rules of illegality to tax evasion transactions and refuse enforcement. The tax laws, although sometimes penal in their nature, are to be construed liberally for the protection of the revenues.

United States v. Ryan, 284 U.S. 167, 172 (1931);
Smythe v. Fiske, 23 Wall. (90 U.S.) 374 (1874);
United States v. Stowell, 133 U.S. 1, 12 (1890).

Our tax structure is based primarily on securing a full and fair disclosure by the taxpayer in his tax return.

Spies v. United States, 317 U.S. 492, 495 (1943);
Helvering v. Mitchell, 303 U.S. 391, 399 (1938);
Balter, "Tax Fraud and Evasion" p. 1.4 (3rd Ed. 1963).

In many countries this just doesn't work. Cheating the tax collector is considered to be fair game. In the United States there is a fair degree of cooperation from at least the majority of taxpayers, but evasion continues to be a serious threat to the system.

"* * * evasion practiced by the small minority of taxpayers breeds disrespect for the tax laws on the part of the great majority who attempt to cut square corners with the Government." (Mortenson, "Federal Tax Fraud Law", p. v (1958)).

See also Balter, "Tax Fraud and Evasion", p. 1.4 (3d Ed. 1963).

Paul, "Taxation for Prosperity", p. 287 (1947).

The significance of subjective good faith must also be considered in the light of these factors. The several cases reviewed *supra*, p. 21 to p. 23 demonstrate that on illegality questions generally good faith is no answer; that the importance of discouraging illegality is such that the Courts cannot afford to get bogged down on the always difficult question of subjective intent.

Should these rules concerning illegality be any more relaxed in the tax evasion field? To what extent does advice

of counsel* in an obviously evasive transaction serve to insulate the taxpayer from the normal consequences of his acts? Certainly it is not a complete shield.

Harry Feldman, 34 B.T.A. 517 (1936);

Coates v. Commissioner, 234 F. (2d) 459 (8th Cir. 1956);

Hermax Co. Inc., 11 T.C. 442 (1948) affirmed *per curiam* 175 F. (2d) 776 (3rd Cir. 1949).

Here again on this good faith issue Congress has not provided any definite guide. Congress has provided that for the most stringent sanction, the criminal prosecution, a showing of willfulness—"evil intent"—is required (*Spies v. United States*, 317 U.S. 492 (1943)). This of course does not mean that the same requirement should be applicable to the purely civil sanction of unenforceability.

We respectfully submit that the reasons why courts refuse enforcement of transactions tainted with illegality are fully applicable in the tax evasion field; and that this is what Congress has intended.

The Marital Deduction Could Not Be Properly Claimed.

The facts of the case are that Mrs. Pendleton made her will in reliance upon her husband's promise to limit his bequest to a life estate and to enter into a written agreement for this purpose. This was the finding of the trial court. It was not modified by the District Court of Appeal and it is therefore controlling as to the facts of the case.

*We should point out that the parties did not follow the advice of counsel. Counsel advised that it would be proper to take the marital deduction so long as no restrictions on the outright bequest to Col. Pendleton emanated from Mrs. Pendleton; but the restrictions which were placed did emanate from Mrs. Pendleton.

United States v. Knott, 298 U.S. 544, 548-549 (1936);
Brainard v. Hubbard, 79 U.S. 1, 9-10 (1871).

It requires no citation of specific authority to demonstrate that under these circumstances the interest which Col. Pendleton received as surviving spouse, as limited by the restrictions which the decedent placed, was terminable so that the marital deduction could not properly be taken. For tax purposes the substance of a transaction is far more important than its form. (See *Gregory v. Helvering*, 293 U.S. 465 (1935)) Specific authority does however exist on the point.

See Treasury Regulations quoted *supra*, pp. 4-5;
Lindsey v. U. S., 167 Fed. Supp. 136 (D. Md. 1958).

If the District Court of Appeal decision is to be construed as holding that it was proper to claim the marital deduction under the circumstances of the case, then such holding is certainly contrary to the clearly expressed Congressional intent in § 812(e)(1)(B) (quoted *supra*, p. 4) that terminable interests are not deductible. If so construed, the District Court of Appeal decision would be a very dangerous precedent in anything as far reaching in its application as the marital deduction under the Federal Estate Tax Law.

We must state again that we do not believe that the District Court of Appeal intended to rule that the marital deduction was properly taken. We present the point, however, in order to cover all possible explanations of the court's decision.

The Specific Issue Involving Evasion of the Marital Deduction Provisions of the Estate Tax Law Is Itself a Problem of Far Reaching Consequence.

The marital deduction, provided for by an amendment of the Federal Estate Tax Law in 1948, opens a fertile field for

tax evasion through the use of a secret trust of the type which respondents are here seeking to enforce. The estate of a married decedent owning separate property is allowed a deduction up to one-half of the "gross estate" for property transferred to a surviving spouse. The purpose of this deduction is to place separate property and community property on approximately equal footing for Federal Estate Tax purposes.

Jackson v. United States, ... U.S. ....., 32 L.W. 4222 (March 23, 1964);

Senate Report No. 1013 (3/16/48), accompanying H.R. 4790 [Revenue Act of 1948], 80th Cong., 2d Sess., reproduced at 2 U. S. Code Cong. Serv. (1948) 1163, at 1190;

4 Mertens, "Law of Federal Gift and Estate Taxation", (1959), p. 438.

It was not the intent of Congress however that property should in this manner escape taxation in the estates of both spouses. Even community property would not have this advantage. In order to insure that property for which the marital deduction was taken would not have the added benefit of being left out of the estate of the surviving spouse it was necessary to require that marital deduction property be left to the spouse either outright or with a general power of appointment which would subject it to estate taxes in the estate of the surviving spouse.

Senate Report No. 1013 (3/16/48), *supra*, 2 U.S. Code Cong. Serv. (1948) 1163, at 1190;

4 Mertens, *supra*, p. 440.

If it is possible through the secret trust arrangement which the parties here adopted to nullify the terminable

interest limitations, then a wide loophole for tax evasion is presented.

We are not here concerned with an isolated problem under the Internal Revenue Code. The most recent available figures, for 1961, will demonstrate its importance. In that year 64,538 Federal Estate Tax Returns were filed. On 30,738 of these, the marital deduction was claimed. The total gross estate shown on all returns was $14,622,073,000. The total deduction from the gross estate claimed on account of the marital deduction was $2,795,891,000. This deduction was more than all other deductions combined. (Internal Revenue Service Publication No. 406 (Nov. 13, 1963) "Statistics of Income — 1960, Fiduciary, Gift, and Estate Tax Returns Filed During 1961", pp. 46, 48).

It becomes apparent that over a period of years there are hundreds of thousands of testators who have faced or will have to face the same dilemma as that which confronted Mrs. Pendleton in the present case. On the one hand, there is a desire to limit the surviving spouse to a life estate so as to insure ultimate distribution to other beneficiaries designated by the testator. On the other hand, there is also a desire to minimize taxes by utilizing the marital deduction. Under the law which Congress has enacted testators with this problem must make a choice. They may accomplish one objective or the other. They cannot legally accomplish both.

There will certainly be a strong temptation on the part of many of these testators to attempt to accomplish both objectives through a secret trust of the same type as that utilized by Mrs. Pendleton. There should be no encouragement provided for those who may be so tempted. This certainly is a situation in which the established rules against enforcement of transactions tainted with illegality should apply.

CONCLUSION

We respectfully submit that the foregoing questions, involving as they do the very basic question of the effect of illegality under the Internal Revenue Code and the more specific question concerning the use of the secret trust device in evasion of Federal Estate taxes, should have the attention of this court.

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